

# Q2

# Wanger Investments Quarterly Letter

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## DEAR SIR/MADAM:

The mood in the country is a mix of panic and fear combined with a fascination with the bizarre. No one is quite sure if the current economic weather system will be a twister that blows the roof off or merely a scary looking storm cell that darkens the sky without doing more harm than scaring the chickens and cows. Daily we read about European debt fears, stock markets crashing, America's credit rating faltering, stalled U.S. GDP growth, the unemployment rate, Chinese inflation, Indian corruption, gridlocked government, etc. If one throws in locusts, hail, and boils, it would seem almost biblical.

But this is not 2008. And that is important to remember. As bad as things feel right now, and they do feel bad, our financial system is not on the brink of collapse. The number of U.S. banks that should be shut down has actually declined a bit, and corporate profits remain high. We did not default on our debt and, politics aside, the United States is not over.

### What Happened to the Year of the Recovery?

With some important exceptions (gold for one), commodities have backed down from their recent peaks and gasoline prices are no longer threatening to cripple the lower end of the workforce. But for most investors, 2011 has become a year of dyspeptic nervousness, already falling short of its original promise.

We had hoped that 2011 would be the recovery year, where the economy proved to be on the mend, where unemployment and housing made a clear bottom, where the U.S. government backed off its aggressive stimulus programs, and when investors came out of hiding. At first it looked like we had all these things. Now it looks like we may have few to none of them: GDP growth estimates for 2011 have now been lowered to an anemic 1.9% and unemployment has lurched back to 9.2% nationally, with pundits writing off any near-term recovery in jobs. Investors, like ground hogs, stuck their head out of their holes and said, short-term rally be damned, its dark and cold out there!

### So Far During Q3 2011...

This letter is coming out after we have seen the extraordinary volatility of August, 2011: The Dow down 600 points in a single, the Russell 2000 off 9% in one trading session. And, ironically, U.S. bonds have been the place to hide, actually increasing in value despite every pundits prediction from only a month or two ago. Once again, the death of the United States has been exaggerated (apologies to Mr. Twain).

All in all, our clients should be pretty happy. Our institutional-style investment model has kept our clients well-diversified beyond the traditional confines of ordinary wealth management strategies. And, as a result, our clients have been able to hold on to a lot more of their money in these volatile markets.

For more information, Email us at: [info@wangerinvestments.com](mailto:info@wangerinvestments.com) or visit us on the web at: [www.wangerinvestments.com](http://www.wangerinvestments.com) or [www.wangeromniwealth.com](http://www.wangeromniwealth.com).

Best,  
Eric Wanger, JD, CFA

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From The Desk of Eric Wanger:

## The Debt Ceiling and Evil Robots From Space

### On Raising the Debt Ceiling

There's not much to say about the debt ceiling fiasco that hasn't been said; I'm just glad the circus is over. Were we seriously considering telling our creditors we were going to start stiffing them because we just realized our spending is out of control? Maybe the next time Congress wants to debate a budget, they'll actually debate a budget!

Dylan Matthews, a Washington Post blogger, points out that the very concept of a federal debt ceiling has been controversial since it was first legislated in 1917. Apparently, it has caused trouble before. In 1957, for example, the Air Force had to stop paying its bills because of the debt ceiling. Matthews quotes a Brookings Institution study that suggests this spending freeze led to a sudden \$8 billion (1.7 percent of GDP) fall in defense spending, which contributed to the 1957-58 recession. (Source: [http://www.washingtonpost.com/blogs/ezra-klein/post/past-research-on-the-debt-ceiling/2011/07/11/g1QAV8U6Y1\\_blog.html](http://www.washingtonpost.com/blogs/ezra-klein/post/past-research-on-the-debt-ceiling/2011/07/11/g1QAV8U6Y1_blog.html).)



Eric Wanger

*For Pete's sake gentlemen, we're now being chastised by Communists on matters of fiscal responsibility!*

### Members of Congress Work Into the Night to Help Restore U.S. Financial Credibility



*But all this bickering seemed designed to destroy our global credibility as quickly and efficiently as possible.*

I'm hugely in favor of big spending cuts. I just want to see a budget debate, not a public display of economic ignorance and financial irresponsibility. Our present and future creditors would surely love it if Congress could produce any budget, especially a vigorously negotiated one. Likewise, I'm sure the whole world would be thrilled if the U.S. could simplify and rationalize its Byzantine (and pork riddled) tax code.

In the end I agree with both Ben Bernanke and Standard & Poors, the only loser in this fight was U.S. financial credibility. If you weren't sure that our legislators would put partisan politics ahead of good fiscal governance, you are now. For Pete's sake gentlemen, we're now being chastised by Communists on matters of fiscal responsibility!

President	Number of Debt Ceiling Increases	Total % Increase in the Debt Ceiling
Kennedy	4	5%
Johnson	7	5%
Nixon	9	36%
Ford	5	41%
Carter	9	59%
Reagan	18	199%
Bush I	9	48%
Clinton	4	44%
Bush II	7	90%
Obama	3	26%

Source: <http://progressivetoo.com>.

### Evil Robots from Space: In 3D

I just took our entire Chicago office to see the greatest movie in the history of the world. And by that I mean, of course, *Transformers 3: Dark of the Moon*. Dark side of the Moon? Nope, just Dark, no Side. Anyway, the last 45 minutes of the movie show our office building — 401 N. Michigan Ave. — and our entire north-of-the-river Michigan Avenue neighborhood being attacked, crushed, killed, and destroyed by giant killer robots, giant evil robotic dirigibles, giant fanged killer worm-snake robots, giant multi-colored robot lasers, and giant robotic aerial drone things that, of course, destroy everything in their path.

We watched the movie being filmed last summer. It was great seeing our entire neighborhood turned into a post-apocalyptic robot-trashed pyrotechnically enhanced wasteland. (And, given that we aren't paying our interns squat this summer, tak-

*Continues on the next page*

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*The Debt Ceiling and Evil Robots From Space (Continued)*

ing them out for bowling, pizza, and a movie was a really cheap way to thank them for an entire summer of hard work.)



*My favorite line was when the German/Austrian accented Freud/Einstein/Von Braun robot turned to the hero of the human resistance and handed him a techno-enhanced set of brass knuckles while stating, "This is my greatest invention — For Kicking Ass!"*

Ironically, there was probably too much swearing for me to feel comfortable taking my own children to see the film, but it made for an ideal office outing, especially when combined with bowling and dirty martinis.

3D movies, as it turns out, represent an investable theme as a sub-sector of the entertainment industry. IMAX Corp. (NYSE: IMAX), RealD (NYSE: RLD), Dolby Laboratories, Inc. (NYSE: DLB), and others were, until quite recently, trading at astronomical valuations, fueled by investment banker and investor-relations hype. Valuations are now more reasonable. We like IMAX the most of the lot. They are in the business of delivering super-large scale movie films and equipment, including, but not limited to 3D films. They have a significant global backlog (nearly 100 facilities) in bringing new theatres online and do not depend wholly on a rapid U.S. recovery to fuel continued growth.



*It was great seeing our entire neighborhood turned into a post-apocalyptic robot-trashed pyrotechnically enhanced wasteland.*

As a research team, we are not totally convinced that 3D is a set of "products" rather than a set of "features." Can 3D capabilities be the sole business of a public company? We're not sure. RLD is just such an example. They clearly made rapid and meaningful inroads into the U.S. theatrical 3D movie market. In fact, they seemed to exclusively capture AMC, Cinemark, and Regal, three of the biggest domestic operators. However, we agree with analysts like Richard Greenfield of BTIG, who wrote: "The major U.S. exhibitors are all paying far too much for 3D technology than they should be (Greenfield had a SELL rating

on RLD at the time of this writing). Overseas, competition is real and building in the 3D technology sector with MasterImage, Dolby, Xpand, and IMAX all trying to grow their presence.

3D effects are certainly cool and will certainly be here to stay. But in competitive industries, clever new features are not always enough to give new players the ability to survive long-term. Remember *American Call Waiting Corporation*? We don't either.

Regardless of the investment implications, we still had a blast experiencing the thrill of an entire squadron of U.S. Airforce Boeing Ospreys flying in low over Lake Michigan to engage the killer robot air force over Navy Pier. Imagine. It made our 3D glasses sing!

Alan Turing (the father of computer science) would be proud of the dialogue. Never before in the history of cinema have the robots gotten all the good lines, turning the entire human race into a lowly bunch of meat-bag straight men. John Malkovich, John Turturro, Frances McDormand, Leonard Nimoy, and even the real Buzz Aldrin joined in the fun.

There's no shortage of fear, anger and uncertainty out there, so we figured it was OK to have some fun. While the markets are unlikely to replay the depths of despair we saw in 2008, it would be naive to expect decades of financial sinning to end in a simple one-dip hangover. It's time we get our house in order. But, even then, it will take us a few more years to put our economy back on a sound footing. But I digress...

As I said, *Transformers 3: Dark of the Moon* was the greatest movie in the history of the world. And yes, Mr. Ralph Wanger, CFA, that includes *Destroy All Monsters*, *Abbott and Costello Meet the Wolf Man*, *Animal House*, *Young Frankenstein*, and *Yellow Submarine*. Did you take your entire office to see the *Blues Brothers* when they trashed Chicago? No, I didn't think so.

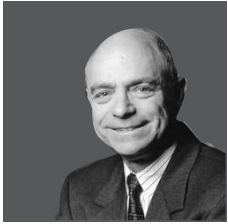
Eric Wanger, JD, CFA

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Ralph Wanger Reports:

## Legislation No — Regulation Yes



Ralph Wanger

*Both of these laws are incredibly long, not very well written, and undoubtedly filled with unforeseen consequences.*

Forty years ago, as a young analyst, I had an embarrassing event. I was following a company that ran a fleet of moving vans. I wanted to know whether they might start paying a dividend, for the company seemed to be profitable and had a decent balance sheet. The company CFO was encouraging but ambiguous, as was the Annual Report. The SEC documents on file were sketchy, but I thought a dividend was likely. The company did not initiate a dividend, and we eventually sold the stock at a loss. What I had missed — the moving van company was considered a truck line, and so was regulated by the ICC, not the SEC. The ICC filings made it clear that no dividend was forthcoming. Don't you make a similar error; be familiar with the regulatory bodies governing any industry you follow. It is very important to know what agencies control the industry you are looking at.

We all that know that legislation affects us in many ways. Two of last year's major laws have yet to be implemented, the Patient Protection & Affordable Care Act (PPACA), which governs healthcare, and Dodd-Frank that regulates financial institutions, including you and me. Both of these laws are incredibly long, not very well written, and undoubtedly filled with unforeseen consequences. Each adds new powers for existing agencies and sets up completely new agencies. Most of the regulations by which these laws will operate have not yet been written.

The passage of these two major laws was time consuming, contentious, and partisan. Does the president want to go to bat for another new major law? None has been announced. I do not believe that any new big law is being planned. No one in the White House or Congress has the energy for another fight, and the 2012 election will soon be the only subject of interest.

This does not mean that important policy changes are not coming. They will not be from legislation; they will be from regulation. We are all used to regulations from major agencies such as the SEC, the EPA, and the FDA. They will continue to bring out new rules which will be important for analysts. For example, the new Consumer Financial Protection Bureau, a curiously structured agency, will have vast power over mortgages, credit cards, and installment loans, with powerful impact on those businesses.

President Obama has been appointing union officials to many regulatory boards. That means that many agencies will be issuing rules to empower labor unions. You have probably read about the NLRB ruling that Boeing may not operate their new 787 assembly plant in South Carolina. The NLRB has also proposed rules to shorten the time for a union certification election. The NLRB has a new chairman, Ms. Wilma B. Liebman,

previously general counsel for the International Union of Bricklayers and Allied Craftworkers, and before that, senior attorney for the International Brotherhood of Teamsters. Another board appointment, Craig Becker, was Associate General Counsel to the AFL-CIO and the Service Employees International Union (SEIU). Mr. Becker was a recess appointment because his pro-union bias made him unconfirmable by the Senate.

Be careful if you are following non-union companies that may run into labor strife. An obvious example is Walmart, which can expect to undergo strong efforts by the unions to organize the company.

You might be blind-sighted by an important new rule coming out of an agency that you never heard of. Last month, I first discovered the National Mediation Board (NMB). This agency was set up by the New Deal in 1934 to "facilitate harmonious labor-management relations for the railroad and airline industries". The new chairman of the NMB is Ms. Linda Puchala, whose previous experience included International President of the Association of Flight Attendants. One of the cases coming up shortly is the attempt of the Delta Airlines flight attendants to unionize.

The NMB has also changed the rule to allow airline and railroad employees to form a union by a simple majority of those voting. Under the old rule, workers who didn't vote were treated as "no" votes. Republicans have objected to this rule change and have responded by blocking legislation to extend the FAA's operating authority. The FAA ban suspended all construction work at airports. It was even possible that air traffic control would be affected, messing up airline travel. After a few days, a compromise was reached, and the FAA returned to normal.

In summary, changes to regulations will be frequent. You will have to find out which ones will affect your investment research and revise your opinions on affected companies accordingly. If you cannot figure out the effect of a new rule, talk to some company officers, because the potential effects can be very different from what your first opinion might be.

Ralph Wanger, CFA, Senior Advisor  
Wanger Investment Management, Inc.

*This does not mean that important policy changes are not coming. They will not be from legislation; they will be from regulation.*

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Family Office Corner – By Suzanne Carrier Campion:

## Teach Your Children Well...

*If you want your kids to be responsible with the mighty dollar, they will do just as you do.*

It can start when your son or daughter asks “are we rich?” Do you disclose everything? Nothing? How do you say “no” when you can basically afford just about anything that you or the kids want? These are some of the most challenging questions affluent families face as they weigh the benefits of having their wealth and wanting their children to be good stewards of their inheritance, while maintaining the values of prior generations.

I’ll steal another phrase from the famous Crosby, Stills, Nash, and Young song: “Teach your children what you believe in... Make a world that we can believe in.”

You send them to great schools, to play on teams, to experiential camps, and look for other growth opportunities, however, are you providing your children with the financial education and with the straight forward talk about your family’s wealth they need? I would like to address how and when to talk with your children about your family’s financial values.

### *Here Are a Few Thoughts*

**Be honest with your children.** Talk with them at an age appropriate level about your family’s wealth. They are smart. If you tell them: “No, we are not rich,” and you buy a new car every year and own three vacation homes, they will know something does not add up. Tell them about how your family earned their wealth. Is there a multi-generational story? You can use this as an opportunity to talk about hard work or pushing for something you believe in. They will have greater appreciation for the effort you and your family have undertaken to achieve success.

**Walk the walk.** If you want your kids to be responsible with the mighty dollar, they will do just as you do. For better or for worse, children are wonderful “mimickers”. This also means saying “no” to them at times, giving them tasks of their own in order to receive an allowance, or perhaps involving them in a hands-on charity event.

**Help them learn.** Teach them about the operations of your business, how to save, or whatever else is important to your family. When they are young, make use of the “3-jar technique” — one for saving, one for spending, one for charity. It actually works! As they get older, set budgets with your children, establish checking accounts and investment accounts for which they are responsible. Bring them to work with you to expose them to your daily routine. You might even consider introducing them to your advisors for some education on the markets, accounting, law, etc.

*Helping your children grow, reach, explore, and develop financially will not only benefit your children in the long-run, it will assist your family in achieving its goals, both financial and non-financial, and preserving its values.*

**Encourage their curiosity.** A child at 7 may want to run a lemonade stand but at 17, may want to and need to intellectually find a part time job or internship. At each stage of development, encourage their interests and help them take on new responsibilities. These children, despite the family wealth, will have to make their own way and make decisions. Helping your children grow, reach, explore, and develop financially will not only benefit your children in the long-run, it will assist your family in achieving its goals, both financial and non-financial, and preserving its values. Communication, verbal or non-verbal, will equip your children with financial and decision making skills as well as the confidence to succeed on their own.

As a multi-family office serving ultra affluent families, Wanger OmniWealth addresses these issues and many more with clients. While each client faces unique opportunities and challenges, we have a robust solution set to meet their needs, both financial and non-financial. Specific to the topic of educating children about financial matters, we often partner with our friend Joline Godfrey of Independent Means. She and her team work with families to formulate and execute plans on how best to educate the multiple generations of a particular family about their wealth. In her book, *Raising Financially Fit Kids*, Joline states: “Financial literacy is economic self-defense. And our collective responsibility as caring adults is to arm the next generation with the skills and knowledge they need to handle themselves in a world in which financial safety nets are being replaced by the imperative of financial self-sufficiency.”

In the meantime, more is more — talking, that is. Trust your children with family knowledge, financial education, and the opportunity to explore. This financial education will develop over time and will mature as your children mature. You never know — you might have the next super-charged entrepreneur on your hands!

If we can be of assistance with this process, or put you in touch with Joline Godfrey, please let us know.

Suzanne Carrier Campion, *Office Managing Director,*  
Wanger OmniWealth, LLC

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# Wanger Investments Quarterly Letter

Bill Andersen:

## Dividend Investing Today

*For the vast majority of common stocks, the dividend record and prospects have been the most important factor controlling investment quality and value—Benjamin Graham, Security Analysis*

*In a recession, the best thing to own is a good business—Warren Buffett, Berkshire Hathaway 2009 Annual Meeting*

*Global Corporations are the new sovereign credits—Unknown*

*Dividends account for 43% of the returns from equities but only get 1% of the attention—William Andersen*

*Dividend payments tend to be predictable and to grow at a steady pace.*

With the world economy facing bigger than usual challenges, investors face difficult choices in making decisions. In mid 2011, equity markets have corrected the severe undervaluation which followed the financial crisis. The yields on high quality fixed income instruments are low and are likely to rise at some point. Yields on medium to lower quality debt offer substantially lower premiums than they did a short time ago. On the positive side, of course, there has been a modest economic recovery in the developed economies and a much more substantial one in many developing ones.

This dilemma comes at the same time that a huge demographic group is retiring. Today's retirees have a longer life expectancy than any group before them. They are also less likely to be covered by a traditional "defined benefit" retirement plan. For them, funding their retirement will be accomplished through a combination of portfolio income, social security, working until a later age, and whatever pension benefit they may have.

For investors with income needs and long life expectancies, dividend income has many advantages. Dividend payments tend to be predictable and to grow at a steady pace. There is substantial research to support this trend, but the general finding is that companies are very reluctant to reduce dividends, and therefore are very careful to set them at levels where they can be maintained and increased. One need only look at the long-term dividend records of many high quality companies to see this.

Dividends also provide investors with substantial protection against inflation. Because they represent a share of the earnings from a corporation, they may be expected to grow as a company's earnings grow. In general, higher inflation will lead companies to raise prices which will lead to increased dividends. Contrast this to the coupon payments on a bond, which remain constant over the life of the instrument. In real dollars those coupons shrink in value each year by the amount of inflation. This may not seem like much, but over ten or twenty years it adds up.

Dividends also are currently favored by U.S. tax policy, which imposed a 15% rate on them compared to the 30% plus rate imposed on coupon payments from bonds.

None of this would matter if dividend paying shares didn't prove to be a sound investment. They have. Studies have shown that shares of companies which pay dividends have substantially outperformed non-dividend paying shares over the long-term. This analysis is particularly interesting given that small company shares also outperform over time, yet there is a large cap bias to dividend paying shares. The corollary might be that investors should be very concerned about large cap companies that don't pay a dividend!

Another significant factor in thinking about dividends is the payout ratio. Interestingly, this number seems to vary from country to country. U.S. companies are notoriously stingy in paying out dividends. There are various explanations offered for this behavior. One is that the tax code has historically discriminated against dividends by taxing them both at the corporate and individual level. This is less true today as dividends are currently taxed at the lower capital gains rate of 15%. In the U.S., share buybacks have been very popular as a way of using earnings to benefit shareholders. Unfortunately there are numerous cases of companies which have spent billions of dollars on buybacks only to see their shares drop in value. It is hard to see how this benefitted shareholders. Another theory is that American managements may prefer to retain earnings as a way to grow their business and their own compensation. Others (including notably Ralph Wanger) have argued that investors (especially institutional investors) have not been diligent enough in demanding that companies share more of their earnings with shareholders.

What are the most attractive ways for investors to seek out dividend paying companies? There are, of course, the usual choices. There are numerous mutual funds available in the "equity income" category. While some of these are excellent, this route may be an expensive way to access the asset class. If a fund invests in quality companies with yields in the 3% range, a fund with an expense ratio of 1 to 1 and a half percent may not work out as well after fees. There are also ETFs which invest in this asset class. The experience of 2008 shows, however, that simply purchasing a passive portfolio of companies with dividends isn't a good strategy as many companies with supposedly secure dividends cut them during the crisis.

### *A New Way of Looking At Equity Income*

Given the importance of equity income to many investors, we think it is time to re-evaluate the approach many take to this asset class. In this section, we propose two new themes for equity income investments, and three suggested criteria.

*Continues on the next page*

*The Corollary might be that investors should be very concerned about large cap companies that don't pay a dividend!*

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*Dividend Investing Today (Continued)*

*A further benefit of investing globally is that, as noted above, in many countries the typical payout ratio, or portion of earnings paid out to investors, is substantially higher than in the U.S.*

The first theme is that equity income investors should look globally for investments. While this may seem obvious at first, the fact is that while many investors have shifted substantial investments overseas (including some fixed income investments) most dividend oriented investments remain domestic. There are several advantages to looking globally. First, as with all international investments, searching globally increases the opportunity set of potential stocks to buy. In the case of dividend investments, however, there are other advantages. A global equity income portfolio provides an income stream diversified by currency, which provides investors with a hedge in the case of a dollar crisis or prolonged dollar weakness. A well chosen portfolio may also concentrate on countries whose currencies have strong long term fundamentals. A further benefit of investing globally is that, as noted above, in many countries the typical payout ratio, or portion of earnings paid out to investors, is substantially higher than in the U. S. This may give investors the potential for higher current income without needing to make riskier investments. For example, a company in the U.S. trading at 15 times earnings with a 30% payout ratio may be compared to one in Australia with a 70% payout ratio. The two companies may appear to be similarly valued, but to the income oriented investor the Australian company is likely to be more interesting.

The second theme we'd propose is that income portfolios should be multi-class. In our view, there are a number of equity income categories which are attractive from time to time depending on fundamentals and valuation. In addition to common stocks, securities such as Real Estate Investment Trusts, Master Limited Partnerships, closed-end funds, convertible and preferred securities can all fit into a yield oriented portfolio. Many of these categories exist for non-U.S. companies as well. Investors have typically either ignored these asset classes, or participated in them through a specialist manager. This approach may sound rational but investors should note it assumes that investors can identify managers with the proper skill set not only to select securities, but also to tell clients candidly when their asset class is unattractive. Our experience is that there is a limited number of managers who can do the first of these things and almost none with the combination of talent and candor to do the second. We believe a better approach is to utilize a manager who has access to all these categories (as well as new ones which arise) and can invest in them opportunistically based on a proven, value oriented philosophy.

We suggest four criteria when searching for income investments. First, the income portion of the investment must be meaningful. By this, we mean that a substantial portion of the total expected return from the security should be income. Consider a stock with a 2% yield and earnings which are expected

to grow at 10% annually. By one measure, the Gordon Growth model, investors could reasonably expect to earn around 12% from holding this share for a period of time. This may be a reasonable return, but most of the expected return is from capital gains. In our view, the income portion isn't the determinant part of this investment. Compare this with a company growing at 5% with a 7% yield. According to the same model, the overall return could be expected to be the same, but the income portion in this case is the most important.

Secondly, income investments should be defensive. Income investors by nature are conservative, and may count on income from their investments. It makes no sense to generate income in a way which will be highly variable or subject to severe impairment during an economic slowdown. The year 2009 was a good test of this, as it was the worst year for dividend cuts since Standard and Poor's started keeping tabs of this in the 1950s. Yet well chosen stocks made it through this period without cutting their payouts. Many managed to maintain their dividend increases.

Thirdly, income should not be derived from financial gimmicks. We would include in this category exotic derivatives, complex options strategies, and excessive trading. We haven't seen strategies in this category which consistently provide superior results to a well developed stock selection strategy. Short-term strategies also generate short-term income, which is taxed at a much higher rate than dividends. This means that such strategies must be superior to traditional strategies if they are to be comparable on an after tax basis.

The generation long bull market has led investors to ignore the income portion of equity returns. This is strange because if equity ownership is a form of business ownership, how could owners fail to ask whether the businesses they owned did or did not generate any cash return. The answer may lie in the human propensity to speculate, the interest in the financial industry in generating stories which lead to securities transactions, or any other number of factors. The fact remains that over time, dividends account for 43% of the total returns from equity investments. Why they only attract 1% of the attention is mysterious, but it may also be an opportunity for investors who believe that it is attractive to focus their activity away from the crowd.

William Andersen, CFA, *Portfolio Manager, Wanger Income and Growth Strategy, and Principal, Andersen Capital Management*

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Investment Write-up:

## Align Technology, Inc. (NASDAQ: ALGN)

Treasure hunting for lost tombs in Egypt continues to this day. A popular fantasy is to discover a mummy elaborately decorated in gold and jewels. An unlikely part of this fantasy is to consider the archaeological significance of what lies inside the mummy's mouth. If that was your concern, there would be occasions when you would find metal bands wrapped around individual teeth — some of the earliest documented evidence of orthodontic practice. Archaeologists speculate that malocclusion (crooked teeth) were at that time corrected using cat gut in a similar way that metal wires are used today.

Common day metal wires and brackets have been the standard of care for many years, but their omnipresence is now being challenged by a new generation of transparent, mouth guard-like aligners. Align Technology, Inc. (NASDAQ: ALGN) gave birth to this market and continues to reap rewards from branding which has achieved Kleenex level recognition in the malocclusion world. The Invisalign treatment is fairly simple. Patients are fitted for transparent retainers which are worn for 20 to 22 hours per day (the retainers are easily removable). At the end of a multi-week cycle the patient is given a new set of aligners which apply pressure to teeth in a similar way to traditional monthly orthodontist adjustments. After many stages of progression (and new retainers) the teeth assume the desired position. The cost of treatment is comparable to traditional braces.

Orthodontic and dental practitioners tend to be conservative in adopting new technologies; normal adoption rates range from four to eight percent growth per year. We believe that the substantially higher growth rate of Invisalign adoption (and stable pricing) reinforces the value added. Clear aligners currently represent 6% of a \$2.6B addressable market. Of that 6% ALGN holds the lion's share with 85% of unit volume or 96% of sales. The remaining 94% of the market is served by standard orthodontic treatment. Further supporting ALGN's competitive positioning is an impressive patent portfolio, which has received public acclaim and, more importantly, been upheld in court.

Perhaps the most important part of this story is that ALGN knows how to sell. They understand their target markets and employ a creative push and pull marketing strategy. We are most interested in ALGN's go to market strategy targeting general practitioners; general dentists dabble in the aesthetic market with teeth whitening and veneers but have historically referred most elective malocclusion cases to orthodontists. Why? ALGN believes that general practitioners feel out of their comfort zone, fear an unfavorable clinical outcome, and are not accustomed to

selling an expensive elective procedure. To address these concerns, ALGN provides sales training, advanced imaging technology, clinical support, and third party financing assistance. Furthermore, Invisalign research and development is ongoing in order to expand its application to more complex cases. In recent memory we cannot recall a better revenue opportunity for general dentists. We also believe that the practice of orthodontics among general dentists will eventually cause orthodontists to adopt Invisalign as a defensive competitive measure.

The desire for a pretty smile is a growing global trend and ALGN is expanding internationally to meet this demand, including complex case studies currently taking place among China's leading Orthodontists. We continue to see evidence of wealthier developing nations adopting western aesthetic trends and believe that ALGN's products are well positioned to benefit from this tailwind.

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